STATE OF MINNESOTA
DEPARTMENT OF COMMERCE
BULLETIN 99-4

Issued this **22**nd day
of October, 1999

TO: ALL LIFE INSURERS AND FRATERNAL BENEFIT SOCIETIES LICENSED IN MINNESOTA

RE: Guaranteed Investment Contract Bailout Provisions

The Department of Commerce of the State of Minnesota ("the Department") has become aware of certain contract provisions that allow a contractholder to surrender its contract in advance of the scheduled maturity date, without a penalty or adjustment that would normally occur. These so-called "bailout" provisions might be triggered by circumstances such as a downgrade in the insurer's claims paying ability or financial strength rating, a default in the payment of any indebtedness for money borrowed or raised by the insurer or any of the insurer's subsidiaries, among other circumstances. In turn, the contract may provide for a relatively immediate cash payment to the institutional contractholder (frequently within 30 days or less) or an alternative course of action to be taken by the insurer in lieu of a cash payment to place the institutional contractholder in an equivalent secure and whole position. Such action might include placing assets in trust equal to the account value under the contract. In each case, these actions are accomplished without any penalty or adjustment that might otherwise be imposed on the contractholder under the terms of the contract.

The "bailout" provisions described in this Bulletin have been fomd in guaranteed investment contracts and similar products that may also be known as funding agreements or deposit agreements (all are referred to as "contracts" in this Bulletin), although they may appear in other forms of contracts as well. The use of these provisions appears to be confined to the "institutional" market (i.e., they appear in contracts sold to large and sophisticated clients).

The Department notes that the triggering events in these circumstances all relate to a worsening financial condition of the insurer. The Department also notes that this penalty free withdrawal or "bailout" right appears to provide a preferential treatment not generally available to other contractholders, especially those that are not institutional purchasers. Finally, the Department believes that the actions required to be taken by the insurer as a result of the triggering event could exacerbate an already worsening financial condition. As a result of the foregoing, the Department believes that such "bailout" provisions are not in the public interest. Therefore, effective October 22, 1999, the Department of Commerce of the State of Minnesota:

1. will no longer approve filings of contracts containing credit rating downgrade and similar "bailout" provisions for issuance in Minnesota; and

2. hereby prohibits the sale of such contracts in Minnesota, regardless of whether such contracts had previously been approved for sale in the State.

Any affected contracts issued and outstanding on the date of this Bulletin may remain in force; however, their renewal will be subject to the provisions of this Bulletin.

Attached is information to further describe the contracts affected by this Bulletin, to clarify the position of the Department of Commerce in regard to these contracts, and to provide additional background for this Bulletin.

Steven M. Minn
Commissioner of Commerce

Guaranteed Investment Contract Bailout Provisions

Background

The following fact sheet was sent to the commissioners of each state insurance department under cover dated August 30, 1999, and is repeated here in its entirety as background on the issue dealt with in this Bulletin:

FACT SHEET

The NAIC Life and Health Actuarial (Technical) Task Force has recently become aware of a development in the Guaranteed Investment Contract (GIC) market that may be of interest to you. GICs are relatively simple products typically used to fund employer/employee pension benefits, municipal obligations, i.e. muni-GICs, and other programs. The chief characteristic of a GIC is the accumulation of an initial consideration at a guaranteed rate of interest for a specified period of time. GICs may provide for a penalty in the event the contractholder cash surrenders the contract prior to maturity. While this fact sheet will use the phrase "guaranteed investment contract" or "GIC," the product may be called by different names such as funding agreement or deposit fund contract.

Some of the life insurers in the GIC market, in response to market demand, have introduced a provision in the contracts they market that permits the contractholder, in the absence of a standard surrender provision and under certain circumstances, to surrender the contract for cash without penalty in advance of the maturity date of the contract. One form of contractual provision waives the surrender charge in the event the insurer's rating has been downgraded, generally by several levels. Another form of the provision requires the insurer to repay the contact holder the account value without surrender charge in the event of the occurrence of any one of several events identified in the contracts. Typical events enumerated in GICs with this type of provision are: default in the payment of any indebtedness for money borrowed or raised by the insurer or any of the insurer's subsidiaries, and the insurer or any of the insurer's subsidiaries fails to pay when due any amount payable by it under any guarantee (howsoever described) of any indebtedness for money borrowed or raised. In some cases, the life insurer may be able to defer or otherwise avoid paying cash to the contractholder by using an alternative course of action described in the contract.

These downgrade and creditworthy contract provisions continue to raise the following concerns for some members of the NAIC Life and Health Actuarial Task Force: Is the event covered a non-diversified risk? Can a non-diversified risk be adequately priced? Are contracts with this provision reserved appropriately for statutory purposes? Does the provision create a preference for a specific class of policy/contract holders? As to the preference issue, the benefit triggers in each situation are related to the deterioration of the financial condition of the insurer. The contractholders of contracts with these provisions may be able to withdraw their funds from the insurer prior to any regulatory action that may be taken. Note that the GICs are purchased by large, sophisticated customers and are often times for large dollar amounts. Withdrawing funds from the insurer in a financially deteriorating situation may be harmful to the remaining policyholders. In effect, some large, sophisticated contractholders may be given a preference relative to the insurer's other policyholders.

It has been brought to the attention of the NAIC Life and Health Actuarial Task Force that some products sold in the corporate owned life insurance (COLI) and bank owned life insurance (BOLI) markets have provisions similar to the ones discussed in this Fact Sheet. This situation creates similar regulatory concerns as previously identified.

It should be noted that external sources of funding such contract benefits arguably solve the non-diversified nature of the risk. External sources include reinsurance or some other form of third party participation in the delivery of the contractual benefit. However, a public policy question remains. That is, to what extent, if any, is the public welfare harmed by the existence of special contractual benefits, which have the effect of exacerbating liquidity and other financial concerns at a time of institutional financial distress ("run-on-the-bank"). For the foregoing reasons, LHATF is looking into these issues for the purpose of providing guidance.

This fact sheet represents the view of the Life and Health Actuarial(Technical) Task Force and has not been adopted as the policy of the National Association of Insurance Commissioners. It is being provided as information to states in their review of insurance contracts.

Conclusions
The background information included in the fact sheet highlights a public policy issue that the State of Minnesota Department of Commerce believes is serious and potentially solvency threatening:

1. The subject category of contracts is sold to and provides preferential treatment to large and sophisticated contractholders. Since the benefit triggers in each situation are related to the deterioration of the financial condition of the insurer, the contractholders of contracts with these provisions may be able to withdraw their funds without penalty or adjustment from the insurer prior to any regulatory action that may be taken. This benefit is not generally available to the company's other contractholders, who may by their contract terms be assessed a penalty or market value or other adjustment should they surrender.

2. The existence of such preferential treatment could threaten the solvency of a company. The large and sophisticated contractholders who purchase contracts with these bailout provisions often do so for very large amounts. If circumstances arise that trigger the benefit, such as an insurer downgrade, subsequent actions required by the contracts to be taken by the insurer to either return funds to contractholders or commit assets to a trust at book value may precipitate or exacerbate a "run-on-the-bank" situation.

Based on the above conclusions, the State of Mimesota Department of Commerce believes that from the standpoint of public policy, the class of contracts subject to this Bulletin is not in the public interest and has issued this Bulletin stopping the further approval and issuance of the subject contracts in this State.

Questions regarding this Bulletin may be referred to:
Blaine Shepherd
Valuation Actuary
Mimiesota Department of Commerce
133 E. Seventh Street
St. Paul, Minnesota 55101
(651) 282-2613